2.8 INFLATION ACCOUNTING

Governments ever rising administrative expenditure, enlarging plan outlays without corresponding increase in productivity and various types of subsidies have given an impetus to inflation. Each one of us experiences the impact of inflation in everyday life. Neither can we wish away inflation nor can we remain insensitive spectators. Problems associated with inflation must be brought in to sharp focus to understand their magnitude.

Inflation Accounting may, therefore, be defined as that technique of accounting by which the financial statements are restated to reflect changes in the general price level.

According to the American Institute of certified Public Accountants (AICPA), "Inflation Accounting is a system for accounting which purports to record as a built in mechanism all economic events in terms of current cost"

Inflation and 'Inflation Accounting' have an effect on various spheres of life. Any system of accounting which takes in to consideration the effects of changing prices, if adopted as a complete replacement to historical cost accounting will require changes in taxation laws, corporate laws Government budget making process, wage negotiation process, pricing, distribution of income, financing decision etc.

Various methods of and approaches towards inflation accounting are equally applicable in a period of deflation. In this study the terms 'inflation accounting' and 'accounting for changing prices' are sometimes used interchangeably.

Needs of Inflation Accounting

In the traditional accounting, assets are shown at historical cost year after year.

Also during the inflationary period historical cost based depreciation would be highly insufficient to replace the existing assets at current cost. Moreover, current revenues for the period are not properly matched with the current cost of operation.

Therefore, the problems created by price changes in the historical cost based accounts necessitates some method to take care of inflation into account system.

Techniques of Inflation Accounting

There is no Consensus on the method to be adopted for adjusting the financial statements for price level changes. Price level changes can be broadly classified into general price level changes and specific price changes.

General price changes reflect the overall increases or decreases in the value of monetary unit. The changes in wholesale price Index (WPI) or the customer price Index (CPI) are example of such price level changes. Specific price refers to change in the price of a specific assets. It is important to note that the price of particular assets may not follow the same trend as WPI or CPI. They are

1. Current Purchasing Power (CPP) method based on changes in general price level changes.
2. Current Cost Accounting (CCA) method based on changes in price of specific assets.

1. Current Purchasing Method

Current Purchasing Method of inflation accounting seeks to use general purchasing power price of money rather than specific indices to convert the historical figure purchasing power for the end of the period in the review.

Calculation of conversion factor is :

- Conversion factor = Price Index at the date of Conversion/Price Index at the date of item arose
- Conversion factor at the beginning = Price Index at the end/Price Index at the beginning
- Conversion factor at an average = Price Index at the end/Average Price Index

- Conversion factor at the end = Price Index at the end/Price Index at the end
- Average Price Index = Price Index at beginning + Price Index at the end/2
- CPP Value = Historical value X Conversion factor

The conversion process is discussed below in following 3 sections :

- Balance sheet at the beginning of the year
- Profit and loss account for the year
- Balance sheet at the end of the year.

For the sake of convenience, the balance sheet is viewed as comparing of 3 parts.

(a) Monetary Assets

(b) Non-Monetary Assets

(c) Shareholder Fund

(a) Monetary Assets : Monetary items are assets and liabilities, the amounts of which are receivable or payable only at current monetary value. Monetary assets include cash, bank, bills receivables, debtors, prepaid expenses, account receivables, investment in bond or debentures, accrued income etc. Monetary liabilities include creditors, account payable, bills payable, outstanding expenses, notes payable, dividend payable, tax payable, bonds or debentures, loan, advance income, preference share capital etc.

(b) Non-Monetary Items : Those items which cannot be stated in fixed monetary value are called non-monetary items. Such items denote assets and liabilities that do not represent specific monetary claims. Non-monetary accounts include land, building, machinery, vehicles, furniture, inventory, equity share capital, irredeemable preference share capital, accumulated depreciation etc. Non-monetary items do not carry a fixed value like monetary items. Therefore, under CPP method, all such items are to be restated to represent current general purchasing power.

(c) Shareholder's Fund : It is not Possible to Convert Shareholders fund i.e. Share Capital + accumulated reserves on historical cost figure into CPP X with the any Specific Index. It is arrived at by subtracting all liabilities at CPP from the assets both fired and current CPP.

2. Current Cost Accounting Method (CCA)

To maintain the operating capability of the enterprise, it is necessary to take in to account the rising costs of assets consumed in generating revenues. The current cost accounting seeks to achieve this by substituting the current cost of assets consumed in place of the corresponding historical cost. The price changes that are considered in this method are changes in specific prices of assets as they affect the individual entity.

"The basic objectives of current cost accounts is to provide more useful information than that available from historical cost accounts alone for the guidance of management of the business, the shareholders and others on such a matter as :

(a) the financial viability of the business

(b) return on investment

(c) pricing policy, cost control and distribution decisions;

(d) Gearing.

The discussion on CCA method of inflation accounting which is followed is based on the statement of SAP issued by the ICA - England Wales.

Current Accounting = Pand L Account related Issue

In determining current cost profit for an accounting period essentially 2 stages are inverted.

- Determining of Current Cost operating Profit
- Determining of Current Cost Profit Attributable Shareholder

Methodology of Determining Current Cost Operating Cost

In order to obtain Current Cost operating Profit from before Interest on historical Cost are Involved :

(a) **Depreciation Adjustment :** This allow for the impact of price changes when determining the charge against revenue for the part of fixed assets consumed during the period. It is equivalent to the difference between the value to the business of part and fixed assets consumed during the period depreciation on historical cost basis.

(b) **Cost of Sales Adjustment (COSA) :** This accounts for the impact of price changes when determining the charge against revenue from stock consumed in the period. It is the difference between the value to the business of stock consumed in earning the revenue for the period.

(c) **Monetary Working Capital Adjustment :** This adjustment represent the amount of additional or reduced finance needed for monetary working capital as result of the changes in represents working capital component after excluding stock.

(d) **Gearing Adjustment :** Gearing is the ratio of borrowed capital and shareholders interest, current cost profit arrived on the above basis denotes operating profit without considering the way in which the business is financed. Generally, a part of the net operating assets of the business are financed by borrowings. Such borrowing being monetary liabilities, repayment rights are fixed, although values of assets which are financed by such liabilities change. In an inflationary period, values of assets increase. When assets are sold, surplus cash is available after meeting liabilities incurred to finance these assets.

Advantage of Inflation Accounting

- Since assets are shown at current values, Balance Sheet exhibits a fair view of the financial position of a firm.
- Depreciation is calculated on the value of assets to the business and not on their historical cost-a correct method. It facilitates easy replacement.
- Profit and Loss Account will not overstate business income.
- Inflation accounting shows current profit based on current prices.
- Profit or loss is determined by matching the cost and the revenue at current values which are comparable-a realistic assessment of performance.
- Financial ratios based on figures, adjusted to current value, are more meaningful.
- Inflation accounting gives correct information, based on current price to the workers and shareholders. In the absence of this, workers may claim for higher wages and shareholders too claim for higher dividends.

Disadvantage of Inflation Accounting

- The system is not acceptable to Income tax authorities.
- Too many calculations make complications.
- Changes in prices are a never ending process.
- The amount of depreciation will be lower in times of deflation.
- The profit calculated on the system of price level accounting may not be a realistic profit.